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SEC Examination Trends Report

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An examination by the Security and Exchange Commission's (SEC's) Division of Examinations (EXAMS) can be intimidating for even the most seasoned registered investment adviser. Anticipating areas of focus, together with conscientious preparation, can help. EXAMS' [2022 Examination Priorities](#) and recent risk alerts address private funds, ESG, retail, cyber and digital assets, among other topics. However, in addition to these priorities, inevitably an SEC exam will focus on risks, conflicts, and compliance challenges specific to that adviser. This report summarizes our observations concerning EXAMS' public priorities and our insights and practical considerations from recent exams.

General Examination Practices

Recent trends we have observed in the investment adviser exams include:

- » Exams staff continue to conduct exams remotely by e-mail and video conferences.
- » More new registrant exams for advisers that have been registered for less than a year (or even less than 6 months), across asset classes.
- » Initial requests for new registrant exams typically include 30-35 separate request items, some with multiple sub-parts and are relatively straightforward.
- » SEC personnel from other Divisions (specifically Investment Management, Trading and Markets and Enforcement) may participate in calls and interviews with registrants.
- » Exam request periods are longer; document requests have standard two-week return dates (which can be extended in many cases if desired); and exam review periods may extend for 24 months.

Digital Assets

In recent exams of advisers engaged in digital asset activities, SEC staff focused on investment strategies, risks, disclosures, and custody. Examiners want to know how firms handle custody for digital assets within private funds and separately managed accounts, details about qualified custodians, and firm policies and procedures concerning the safeguarding of digital assets. Examiners also focused on advisers' disclosures about their digital asset activities and whether they consider those assets to be securities. A recent [EXAMS digital assets risk alert](#) highlighted several of these same focus areas. In many situations, including custody, there are more questions than answers.

Environmental, Social, and Governance (ESG)

ESG has been an area of heightened SEC focus. As investor interest and demand for ESG-focused investments have increased, so has the attention of regulators worldwide. As the regulations around ESG investments continue to evolve, it is not surprising that EXAMS is asking firms that promote their ESG strategies for more details about how they incorporate specific ESG factors into their investment process.

In 2021, the Private Funds Unit within EXAMS conducted an ESG sweep directed to registered investment advisers to private funds. Since the sweep concluded, ESG exams continued with more granular requests focused on ESG scoring, ESG service provider diligence, greenhouse gas (GhG) emissions, compliance or internal audit evaluations, and ESG-related parameters, restrictions, or instructions for proxy voting. EXAMS staff have requested substantiation of ESG statements, including policies and procedures, explanations about ESG criteria that was a determinative factor in the investment decision-making process, and proxy voting criteria and records.

Cyber

Cyber exams have focused on investment advisers' policies and procedures addressing client/customer information protection and preventing unauthorized access to client/customer accounts or information. More recently, examiners have included more requests concerning governance and supervision, as well as incident response documentation and policies and procedures, vendor due diligence and risk management, and supply chain risk assessment and controls. In some cases, exams or inquiries have arisen due to publicity around breaches applicable to an adviser.

Off-Channel Communications

The SEC [recently ramped up its focus](#) on the use by an adviser's employees of text and other messaging apps (e.g., WhatsApp, WeChat) for business and on the compliance with recordkeeping obligations relating to such communications. Consistent with that focus, EXAMS is including a question in its initial requests asking registrants to explain steps taken to monitor, review, and retain electronic communications related to the advisers' business, including texts and messaging. The request contains detailed questions concerning the adviser's practices, policies and procedures. Examiners also have been probing this topic during the course of exams, including when interviewing individual employees.

MNPI - Alternative Data, Expert Networks and Other Information Sourcing

An adviser's compliance policies and procedures concerning material non-public information (MNPI) continue to be an exam priority. Current trends include requests concerning personal trade monitoring that assume advisers use technology solutions for personal trade monitoring, and more frequent requests for brokerage statements for employees' personal accounts.

EXAMS has also expanded its inquiries concerning sources of potential receipt of MNPI. In particular, EXAMS staff is focused on the due diligence process and recordkeeping around information providers, including alternative data providers. EXAMS staff is honing in on the content and frequency of adviser's due diligence of such providers and the reasonableness of its policies and procedures.

As discussed in its [Risk Alert on Investment Adviser MNPI Compliance Issues](#), EXAMS staff is also scrutinizing other sources of potential MNPI, including "value added investors," defined by EXAMS as investors who are likely to possess MNPI through business, political, or personal contacts or other avenues of access to information. For example, value added investors may include clients and investors that are officers or directors at a public company, principals or portfolio managers at other asset management firms, investment bankers, and expert networks. EXAMS staffers ask whether an adviser has procedures to identify and track advisory clients or investors that are likely to possess MNPI and address the risk posed by those clients or investors. EXAMS staff also scrutinizes advisers' relationships with affiliates and office-sharing arrangements to determine whether those relationships or arrangements pose a risk of an adviser receiving MNPI, and whether those risks are adequately addressed by the advisers' compliance policies and procedures.

Private Funds

In addition to fundamental investment adviser compliance issues, EXAMS continues to examine private fund advisers on a range of topics, including (but not limited to):

- » Fees and expenses, including expense allocation (between funds and manager or among funds, often with a particular focus on co-investments) and the disclosure and handling of internally generated expenses charged to funds, as well as fees paid to affiliates of the adviser.
- » Rule 206(4)-2 custody rule compliance (especially, as noted above, in the digital assets context).

- » Allocation of opportunities (including co-investments) between clients, between clients and proprietary investors, and between clients and “the house.”
- » Side-by-side investing, including with mutual funds and/or managed accounts.
- » Private fund managers who undertake to advise (or sub-advise) registered investment companies.
- » Principal transactions and cross trades.
- » Extension of the life of private equity funds, including factors considered, communications provided to investors concerning plans to extend, requests to extend, and approvals of such extensions.
- » Continuation funds and adviser-led secondary transactions.
- » Consistency of disclosure between Form ADV, offering memoranda, investor letters and marketing materials.

These requests track the observations identified in recent EXAMS risk alerts ([here](#) and [here](#), as well as the SEC’s recently proposed rules concerning private funds ([here](#) and [here](#)).

Mutual Funds and Other Registered Investment Companies

Exams of managers to registered investment companies typically include requests involving compliance with Investment Advisers Act (including as outlined above) as well as Investment Company Act requirements. Recent exams have focused on the following Investment Company Act issues, among others:

- » Transactions with affiliates that are either prohibited or regulated by Section 17 of the Investment Company Act and the rules thereunder.
- » Compliance with rules governing, among other things, valuation (Rule 2a-5) and derivatives (Rule 18f-4).
- » Sufficiency of periodic reporting, CCO and compliance resources and annual compliance reviews required by Rule 38a-1 under the Investment Company Act.
- » Board composition, governance, meetings and recordkeeping.
- » Policies and procedures relating to appropriate share class distribution.
- » Annual approval of investment advisory and distribution agreements, and Rule 12b-1 plans.
- » Regulatory reporting, including shareholder reports, Form N-CSR, Form N-Q and Form N-PX.
- » Timely filing of post-effective amendments and registration of additional shares.
- » Senior securities.
- » Securities lending.
- » Market timing and late trading.
- » Expense caps and fee waivers.
- » Compliance with exemptive orders, if applicable.

Getting Ready

Preparing for an SEC exam can be challenging. One of the best ways to be ready is to have a compliance program in place that is tailored to address your firm’s business and its risks. The program should include testing and monitoring of the firm’s policies and procedures that is documented and can be produced quickly. Additionally, the SEC has become much more open about the examination process. For example, EXAMS routinely provides advisers with summaries of exam findings and their latest areas of focus. Firms should be reviewing EXAMS risk alerts and using them as a tool for improving compliance practices. A firm’s compliance program should be dynamic and address new issues and changes to business practices as they arise.

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